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Federal Communications Commission
Office of Secretary

Jonathan Nuechterlein

2445 M STREET NW
WASHINGTON, DC 20037
+1 202 663 6850
+1 202 663 6363 fax
jon.nuechterlein@wilmerhale.com

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July 29, 2005

Marelene Dortch, Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Re: *Special Access Rates for Price Cap Local Exchange Carriers*, WC Docket No. 05-25, RM-10593

Dear Ms. Dortch:

Enclosed for filing in the above referenced proceedings please find the original and nine (9) copies of the **REDACTED** version of the Reply Comments of SBC Communications Inc. The confidential and unredacted version of SBC's Reply Comments is being filed under separate cover.

I am also providing an additional copy of SBC's Reply Comments to be file-stamped and returned to me. Please contact me at 202-663-6850 if you have any questions.

Respectfully submitted,

JENuechterlein

Jonathan E. Nuechterlein

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JUL 29 2005

Federal Communications Commission
Office of Secretary

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
Special Access Rates for Price Cap Local Exchange Carriers	)	WC Docket No. 05-25
AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services	)	RM-10593

REPLY COMMENTS OF SBC COMMUNICATIONS INC.

Christopher M. Heimann
Gary Phillips
Paul K. Mancini
SBC COMMUNICATIONS INC.
1401 Eye Street, NW
Washington, DC 20005
(202) 326-8800

Jonathan E. Nuechterlein
Jonathan Frankel
David Mendel
Daniel McCuaig
Will T. DeVries
WILMER CUTLER PICKERING
HALE AND DORR LLP
2445 M Street, NW
Washington, DC 20037-1420
(202) 663-6000

Counsel for SBC Communications Inc.

July 29, 2005

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INTRODUCTION AND SUMMARY

In 1989, the Commission broadly embraced "a policy judgment that incentive-based regulation is superior to rate of return for the regulation of certain dominant carriers, including local exchange carriers."[1] Six years later, the Commission reaffirmed that judgment and further found that, unlike rate-of-return regulation, price cap regulation can and should "act as a transitional system as LEC regulated services," such as special access, become "subject to greater competition."[2] In 1999, the Commission continued this transition by adopting pricing flexibility rules to advance its central policy objective—to help competition "replace[] regulation as the primary means of setting prices."[3] In doing so, the Commission made clear that "competition can be expected to carry out the purposes of the Communications Act more assuredly than regulation" ever could, and that regulation is therefore appropriate "only where and to the extent that competition remain[s] absent in the marketplace."[4]

As SBC explained in its opening comments, the market has more than vindicated the Commission's longstanding policy of relying on competition whenever possible to promote consumer welfare in the provision of special access services. Indeed, wireline and intermodal competitors enjoy increasing success in MSAs of all density levels. Wireline CLECs have won

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1 Second Report and Order, *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786, 6789 ¶ 21 (1990) ("*LEC Price Cap Order*") (citing Report and Order and Second Further Notice of Proposed Rulemaking, *Policy and Rules Concerning Rates for Dominant Carriers*, 4 FCC Rcd 2873, 2931-33 ¶ 113 (1989)).

2 First Report and Order, *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961, 8989 ¶ 64 (1995) ("*LEC Price Cap Review Order*").

3 Fifth Report and Order and Further Notice of Proposed Rulemaking, *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers*, 14 FCC Rcd 14221, 14224 ¶ 2 (1999) ("*Pricing Flexibility Order*").

4 *LEC Price Cap Review Order* at 8989 ¶ 64.

substantial and increasing market share since the inception of pricing flexibility, and ILECs are already minority players in the market for OCn-level special access services. Intermodal competitors have begun winning substantial market share as well, particularly for DSn-level services. In fact, **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** of SBC's retail DS1 customer losses have been to cable providers, which are rapidly expanding their footprints from residential to business markets. And because these intermodal competitors bypass ILEC networks altogether, they fly under the radar of the Commission's collocation-based tests for gauging competition levels, as do many other competitors that provide Type 1 services over their own networks or that make use of competitive "collocation hotels." If anything, therefore, those tests are underinclusive, not overinclusive, as some have argued.

As SBC has further observed, this growing competition has translated into lower prices for special access customers. Although some prices have risen, as they do in any competitive market, the average prices that customers actually pay in Phase II MSAs (which factor in any individual price increases) have decreased significantly since the grant of flexibility. Indeed, SBC's average prices for even the *least* competitive special access services (DS1 services) have declined by **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** percent in Phase II MSAs in the last five years, even before inflation is taken into account.[5] Just as important, the prices are not just lower overall, but more economically

[5] Declaration of Parley C. Casto on Behalf of SBC Communications Inc., filed in WC Docket No. 05-25 on June 13, 2005, ¶ 56 ("Casto Initial Decl."). *See also* Reply Declaration of Parley C. Casto on Behalf of SBC Communications Inc., filed in WC Docket No. 05-25 on July 29, 2005, at Table 1 ("Casto Reply Decl.") (Tab B) (showing that this **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** percent

efficient. Like prices elsewhere in the economy, they are now set by the forces of supply and demand, not by command-and-control regulation. By encouraging competitive supply where needed, and by freeing prices to seek their competitive equilibriums, the Commission's free-market policy has ensured that special access customers benefit in both the short and long runs.

Although special access customers are, by any objective measure, better off today than at the advent of pricing flexibility in 1999, some of them nonetheless ask the Commission to give up on the market and force prices down even further by regulatory fiat. This is hardly surprising. The carriers and large business customers that purchase special access could not be expected to pass at the opportunity to increase their profit margins. What is noteworthy, however, is *how few facts* they provide to justify this proposed reversal in longstanding Commission policy. That evidentiary deficit should give the Commission serious pause. While the Commission has the "theoretical right to modify, or even overrule, long-standing precedents, . . . abrupt shifts in policy do constitute 'danger signals' that the Commission may be acting inconsistently with its statutory mandate."[6] Thus, the burden is on the proponents of re-regulation to show that the last fifteen years of Commission policy have been a mistake, and that reimposing intrusive regulation in this age of increasing intra- and intermodal competition could serve consumer welfare better than the market can. They have not come close to meeting that burden.

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decline in nominal prices equates to an **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** percent decline in real prices).

6 *Office of Communication of the United Church of Christ v. FCC*, 707 F.2d 1413, 1425 (D.C. Cir. 1983) (citing *Joseph v. FCC*, 404 F.2d 207, 212 (D.C. Cir. 1968)); *see also National Fed'n of Fed. Employees v. FLRA*, 2005 WL 1412420, *2 (D.C. Cir. June 17, 2005) ("agencies act arbitrarily and capriciously when they ignore their own relevant precedent") (internal quotation marks omitted).

First, there is no evidentiary basis for claims that competition in the special access market is developing too slowly. Whereas SBC has presented hard evidence on the pace and scope of market entry, the advocates of re-regulation offer only anecdotes and empty rhetoric about "disappearing CLECs" and a supposed "lack of choices." Instead of looking at the actual marketplace, they speculate at length about *theoretical* barriers to entry—barriers that, in the real world, many competitors have demonstrably, and increasingly, overcome. To the extent these commenters provide any market data at all, their analysis typically conflates the disparate competitive characteristics of different markets, which undermines any value their data might otherwise have as a basis for re-regulating currently deregulated markets. For example, these commenters embed within their analysis the state of competition for DSn-level services in less competitive *price-cap* MSAs, but those market conditions have little bearing on the success of pricing flexibility for those and other services in the vastly more competitive *Phase II* MSAs.

Because these advocates of re-regulation can make no direct showing that competition is failing to progress in price flex areas, they next try to make the same case indirectly by claiming that special access *prices* are somehow "too high." In several different respects, however, they play fast and loose with the evidence. First, they inflate apparent prices by focusing exclusively on tariffed base rates,[7] which are analogous to the premium rates one might pay for individual airline tickets on the day of departure. But SBC has responded to growing competition by offering large discounts from those base rates. The average rates that customers *actually pay* for

7 In these comments, the terms "base rates" and "tariffed base rates" refer to undiscounted month-to-month tariff rates.

special access services in price flex MSAs, most accurately measured by SBC's average revenue per unit, have thus decreased significantly during the past five years.[8]

Second, the advocates of re-regulation compare these marginally relevant base rates to meaningless benchmarks that reveal nothing about where prices in a competitive special access market should be. These proffered benchmarks include price-cap rates forced down by years of mechanical X-factor reductions that no one has ever justified economically; the rates for transcontinental fiber laid along railroad tracks in wide-open spaces; indeterminate CLEC rates; and rates derived from TELRIC, whose application the Commission has long discredited in this context. In particular, even before the Commission severely questioned TELRIC in a still-pending rulemaking proceeding,[9] it had taken pains to keep artificially low TELRIC rates from undermining special access pricing mechanisms, in part to avoid "undercut[ting] the market position of many facilities-based competitive access providers," a "mature source of competition in telecommunications markets."[10]

The proponents of re-regulation next turn from ILEC special access *prices* to ILEC special access *margins,* relying as before on ARMIS data for the proposition that ILECs earn unseemly rates of return. But these supposed overearnings are just artifacts of ARMIS's

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8 *See* Casto Initial Decl. ¶ 56 (discussing DSn-level services specifically). Indeed, with limited exceptions, even SBC's base rates in Phase II MSAs have not increased, even in nominal terms, above those in effect in 2001, when Phase II pricing flexibility was first implemented in SBC's territory. *Id.* ¶ 58 & n.49.

9 Notice of Proposed Rulemaking, *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, 18 FCC Rcd 18945 (2003) ("*TELRIC NPRM*")

10 Supplemental Order Clarification, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996,* 15 FCC Rcd 9587, 9597 ¶ 18 (2000) ("*Supplemental Order Clarification*"), *aff'd, Competitive Telecomms. Ass'n v. FCC*, 309 F.3d 8 (D.C. Cir. 2002).

misallocation of costs and investment to different categories of service—errors that make ARMIS data essentially worthless as a tool for calculating rates of return on individual categories of interstate services like special access.[11] These errors have grown only more pronounced since the Commission's separations freeze, which produces a widening chasm between reality and the accounting books concerning the percentage of ILEC investment attributable to special access services.[12] Because ARMIS radically understates special access *costs* while accurately reporting special access *revenues,* the result is a grossly overstated rate-of-return figure for these services. And even if these service-specific ARMIS numbers did cast light on the profitability of special access services, it would be arbitrary and capricious to slash special access margins in isolation while leaving intact the miniscule (and sometimes negative) margins that ILECs earn on many of their other regulated services. Indeed, these latter margins dragged the BOCs' aggregate enterprise-wide rates of return—the only meaningful rates of return that the ARMIS data can yield—down to a modest 13 percent average for 2004.[13]

The forms of re-regulation proposed by these commenters would also be as harmful to consumers in the long run as they are unnecessary to protect consumers in the short run. First, "reinitializing" rates to bring them closer to some rate-of-return benchmark would, like any other form of rate-of-return regulation, greatly weaken the incentives of regulated parties to act efficiently in the future—the very regulatory dilemma that caused the Commission to abandon rate-of-return regulation for price caps in the 1990s. Second, it would be just as arbitrary to

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[11] *See* Declaration of David Toti on Behalf of SBC Communications Inc., filed in WC Docket No. 05-25 on June 13, 2005, ¶¶ 3-5, 16-18, 42 ("Toti Initial Decl.").

[12] *See* Toti Initial Decl. ¶¶ 16-20.

[13] *See* Toti Initial Decl. ¶ 39.

subject special access rates to an X- or g-factor, either to accomplish essentially the same margin-reducing outcome as explicit reinitialization or to reflect hypothetical efficiency gains unique to special access services. The courts have repeatedly invalidated the Commission's efforts to ratchet interstate access rates down through mechanical X-factor formulas in the absence of hard evidence that those formulas accurately reflect any efficiency gains in the interstate access market beyond those felt in the economy as a whole.[14] Here, there is no evidence of such efficiencies, and the likely result of any effort to impose a new X- or g-factor would just be litigation and eventual judicial invalidation.

Third, no party has identified a better proxy for competitive entry than the current collocation-based triggers, and any alternative would be worse. Although some commenters argue that such triggers overestimate entry, the reverse is true. As noted, those triggers fail to capture facilities-based competition that bypasses the ILEC network, such as intermodal competitors and wireline CLECs that provide Type 1 services or that collocate in carrier hotels rather than ILEC central offices. Likewise, determining pricing flexibility on the basis of wire centers rather than MSAs, as some have proposed, would serve no useful purpose and would simply hinder the footprint-wide pricing arrangements that both suppliers and purchasers of special access services prefer.[15]

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14 *See, e.g.*, *United States Tel. Ass'n v. FCC*, 188 F.3d 521 (D.C. Cir. 1999) ("*X-Factor Decision*") (invalidating X-factor as unsupported by substantial evidence of productivity enhancements).

15 Casto Initial Decl. ¶¶ 9-10; *see also* Casto Reply Decl. ¶ 52.

Finally, the Commission should reject calls to restrict the ability of ILECs to offer their customers term, volume, multiproduct, or geography-wide discounts.[16] Such discounts are presumptively pro-consumer unless they involve either (i) predatory below-cost pricing or (ii) an illegal tying arrangement, under which a customer *cannot* purchase one product without purchasing another. The discount plans at issue here involve neither predatory pricing nor tying, and any new prohibitions in this area would leave customers worse off by preventing ILECs from offering service packages that respond to the needs and desires of customers. Indeed, discount plans come in so many forms, and can have such divergent effects depending on context, that trying to catalog and regulate them all *ex ante* in a rulemaking would be a fool's errand. If customers or competitors believe that a particular discount program violates the Act, they can always ask the Commission to examine it in a section 208 case.

If anything, the Commission should grant ILECs additional flexibility to respond to competition by developing pricing arrangements that best meet the needs of their customers. For example, the Commission should make clear that ILECs may respond to their customers' increasing demand for discounted offerings on all services without regard to jurisdictional limits (such as for bundles of interstate and intrastate services), and for deeper discounts based on growth in purchase volumes. Competing providers of special access and other high-capacity services are virtually unregulated, need not make arbitrary distinctions between interstate and

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[16] *See* Initial Comments of WilTel Communications, LLC, filed in WC Docket No. 05-25 on June 13, 2005, at 13-15 ("WilTel Comments"); Comments of CompTel/ALTS, Global Crossing North America, Inc., and NuVox Communications, filed in WC Docket No. 05-25 on June 13, 2005, at 11-20 ("CompTel/ALTS Comments"); Comments of ATX Communications Services, Inc., Bridgecom International, Inc., Broadview Networks, inc., Pac-West Telecomm, Inc., US LEC Corp., and U.S. Telepacific Corp. d/b/a Telepacific Communications, filed in WC Docket No. 05-25 on June 13, 2005, at 35-39 ("ATX Comments").

intrastate services, and face no legal uncertainty about their ability to win new business through aggressive discount plans. Artificially restricting the ability of ILECs to compete on equal terms would simply harm consumers.

In sum, as SBC proposed in its opening comments, the Commission should reaffirm the basics of its existing special access regime but fine-tune the rules to allow market forces to govern more directly where competition has taken hold. First, the Commission should embrace the broad consensus in favor of giving ILECs unlimited downward (Phase I) pricing flexibility for *all* special access services. And it should completely deregulate contract tariff offerings absent clear evidence of predatory below-cost pricing or illegal tying. Second, the Commission should grant ILECs Phase II pricing flexibility for all OCn-level services and packet-switched services—which, as the Commission has recognized, are contestable everywhere they are not already competitive[17]—nationwide, for *all* serving areas. Third, the Commission should streamline its current basket structure for special access services by replacing the existing four service categories with two: one category for DS3-and-below channel terminations to end users,[18] and a second category for all other DS3-and-below special access services that remain

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[17] Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Deployment of Wireline Services Offering Advanced Telecommunications Capability*, 18 FCC Rcd 16978, 16985-92, 17168-70, 17321-23 ¶¶ 7, 315-18, 537-41 (2003) ("*Triennial Review Order*"), *vacated in part sub nom. United States Telecomms. Ass'n v. FCC*, 359 F.3d 554 (D.C. Cir. 2004) ("*USTA II*"), *cert. denied, National Ass'n of Regulatory Utility Comm'rs v. United States Telecomms. Ass'n*, 125 S. Ct. 313 (Oct. 12, 2004), *on remand*, Order on Remand, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers,* 20 FCC Rcd. 2533 (2005).

[18] All parties agree that DSn end user channel terminations are the special access services subject to the least competitive pressure, at least for the moment. Confining these services to

subject to price caps. These adjustments preserve the Commission's long-justified faith in the free market while maintaining some residual oversight in the particular segments of the market where the transition to full competition is not yet complete.

DISCUSSION

I. The Special Access Market Is Robustly Competitive.

As SBC and others have demonstrated,[19] competition has flourished in every market where there is significant demand for special access services. The few commenters that even attempt to provide contrary market data offer only inaccurate and misleading information. Likewise, there is no plausible basis for suggestions that the SBC/AT&T merger could decrease the level of competition in the special access market.

A. Competition Has Flourished in Every Market Where There Is Significant Demand for Special Access Services.

As SBC explained in its opening comments, the average number of active, wireline competitors in SBC's Phase II MSAs has nearly doubled since 1999,[20] and increased in some

their own basket would eliminate any concern that they could be priced at supra-competitive levels in non-Phase II MSAs.

[19] SBC's Opening Comments filed in WC Docket No. 05-25 on June 13, 2005, at 9-20 ("SBC's Opening Comments"); Casto Initial Decl. ¶¶ 6-53; Declaration of Professor Joseph P. Kalt on Behalf of SBC Communications Inc., filed in WC Docket No. 05-25 on June 13, 2005, at Fig. 1 ("Kalt Initial Decl."). *See also* Comments of Verizon, filed in WC Docket No. 05-25, June 13, 2005, at 24-35 ("Verizon Comments"); Comments of BellSouth, filed in WC Docket No. 05-25, June 13, 2005, at 23-37 ("BellSouth Comments").

[20] SBC's Opening Comments at 9-10; Casto Initial Decl. ¶ 6. As Professor Joseph Kalt notes, the steady nature of the increase is good evidence that the new competition is not the result of a "euphoric" short-lived burst following deregulation. Kalt Initial Decl. ¶ 35.

markets three- or four-fold.[21] While some of these competitors exited the market during this period, they were replaced by others, resulting in a net increase in wireline competitors in virtually all of the MSAs in which SBC has been granted pricing flexibility.[22] Since 1996, these competitors have invested tens of billions of dollars in new facilities and increased their fiber-route miles many times over, mostly to target the price-cap LECs' special access and enterprise customers.[23] As of 2001, wireline CLECs already occupied approximately 30 percent of the special access market overall,[24] and have continued to expand their networks and competitive special access offerings since then.[25] Indeed, these CLECs have now won the lion's share of OCn-level business within SBC's traditional service region.[26] Although competitors have gained DSn market share at a slower pace, they have made the infrastructure investments necessary to increase their gains dramatically: In 30 Phase II MSAs across SBC's territory, over **[BEGIN**

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21 *See, e.g.*, Kalt Initial Decl., Fig. 1 (noting that the number of wireline competitors to SBC in the special access market in Abilene, TX increased from zero in 1999 to four in 2004, and in Los Angeles from four in 1999 to 13 in 2004).

22 *See, e.g.*, *id.* at Fig. 2 (noting, for example, that, between 1999 and 2005, several competitors—such as e.spire, ICG, McLeodUSA, and Adelphia—exited the market in Austin, only to be replaced by other carriers, increasing the number of providers from five in 1999 to nine in 2004). In none of the MSAs examined by SBC did the number of competitors decrease. *See id.* at Fig. 1.

23 *See, e.g.*, UNE Fact Report 2004, *Unbundled Access to Network Elements; Review of the Section 252 Unbundling Obligations of Incumbent Local Exchange Carriers*, filed in WC Docket No. 04-313, CC Docket No. 01-338, at I-7 (filed Oct. 4, 2004) ("UNE Fact Report 2004").

24 Competition for Special Access Service, High-Capacity Loops and Interoffice Transport, Submitted by the United States Telecom Ass'n, prepared for BellSouth, SBC, Qwest, and Verizon, filed in CC Docket No. 96-98 (filed Apr. 5, 2001), at 5.

25 *See* Kalt Initial Decl., Fig. 1; UNE Fact Report 2004 at I-11; *see also id.* at I-17 (quoting Time Warner Telecom's 2004 claim that it had "[i]ncreased the number of buildings served directly by the Company's fiber network by 24%, year over year"); Casto Initial Decl. ¶¶ 6, 12.

26 Casto Initial Decl. ¶ 7.

CONFIDENTIAL INFORMATION] **[END CONFIDENTIAL INFORMATION]** of DS1 demand and **[BEGIN CONFIDENTIAL INFORMATION]** **[END CONFIDENTIAL INFORMATION]** of DS3 demand is now within 1000 feet of *known* competitive fiber.[27]

This increased fiber deployment has been accompanied by steady growth in collocation at SBC's central offices.[28] CLECs are plainly making substantially greater *use* of these collocation arrangements as well, as evidenced by the rapid growth in the number of cross-connects. SBC's central offices now house more competitors with cross-connects than with collocation arrangements.[29] In addition, competitors are increasingly collocating at non-ILEC "carrier hotels,"[30] from which they can typically gain access to one another's fiber-optic transmission

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27 *See id.*, Attach. 2. Even these numbers understate, probably significantly, the percentage of SBC's DS1 demand that is adjacent to existing CLEC fiber. As Mr. Casto makes clear, the fiber maps attached to his initial declaration depict only known CLEC fiber routes based on data obtained by SBC's vendor. These data are underinclusive. As the maps show, SBC has identified CLEC fiber collocated in central offices in many of SBC's wire centers that its vendor has *not* mapped. *Id.* ¶ 14 n.12. Further obvious evidence of their under-inclusiveness is the fact that these data exclude altogether the significant fiber deployments of MCI and Time Warner in Milwaukee. While SBC gas not attempted to identify other omissions, such a glaring omission strongly implies that there undoubtedly are others as well. Thus, it is clear that if CLECs were required to submit their own data, those data would show significantly greater deployment of competitive facilities.

28 *See id.* ¶ 25; *see also* UNE Fact Report 2004, App. E at E-1-E-2 (showing fiber-based collocation in wire centers serving 59 percent of the total lines in 82 large and mid-size MSAs).

29 *See* Casto Initial Decl. ¶ 25. As Mr. Casto has explained, these data indicate that competitors are in many cases leasing facilities from one another to serve special access customers, and thus decreasing their reliance on SBC's special access service components (such as transport). *Id.* ¶ 26.

30 There are over **[BEGIN CONFIDENTIAL INFORMATION]** **[END CONFIDENTIAL INFORMATION]** known carrier hotels in SBC's service territory. *Id.* ¶ 28.

networks and thus indirect access to any SBC central offices or tandem offices that are connected to those networks.[31]

These measures of strong and increasing competitive entry by wireline carriers in the special access market remain uncontested. There can be no dispute that more wireline competitors are serving more special access customers than ever before.

Nor is there any serious dispute that intermodal competition, which the collocation triggers ignore, is already a powerful force and growing more powerful each year. First, the Commission must now recognize that cable operators not only lead the mass market for broadband service,[32] but have become serious players in the special access market as well. Using their existing facilities, cable providers have access to an estimated market of over 20 million business lines,[33] and they are actively expanding their fiber-to-the-curb infrastructure to include business customers.[34]

For example, Cox Communications, which increased its access line penetration from 960,000 to 1.5 million voice grade equivalents in 2003 alone, now offers special access bandwidth from DS1 to OC192.[35] Its website boasts that Cox has "delivered customized voice, data and video solutions to more than 100,000 commercial customers nationwide, from small

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31 *Id.* ¶ 28; UNE Fact Report 2004 at III-17.

32 *See United States Telecom Ass'n v. FCC*, 290 F.3d 415, 428 (D.C. Cir. 2002), *cert. denied sub nom. WorldCom, Inc. v. United States Telecom Ass'n*, 538 U.S. 940 (2003).

33 Casto Initial Decl. ¶ 37.

34 UNE Fact Report 2004 at III-25.

35 Casto Initial Decl. ¶¶ 38-39.

firms to large enterprises, in many different industries and sectors."[36] And Comcast, with as many as 4 million small and medium-sized businesses within 200 feet of its fiber and coaxial infrastructure, expressly targets organizations "with 1-100 employees"—the heart of the BOCs' DS1 and DS3 customer base.[37] Comcast's most recent marketing campaign trumpets its ability to provide "the ultimate high-speed service for your growing business" with "download speeds [7 Mbps] up to 4 times faster than a T-1."[38] In fact, as Verizon declarant Lew catalogs,[39] *all* major cable companies are now specifically targeting the enterprise special access market. These statements are not mere puffery; **[BEGIN CONFIDENTIAL INFORMATION]**

[END CONFIDENTIAL INFORMATION] of SBC's retail DS1 losses are to cable companies.[40]

Likewise, the Commission must take into account the market-altering reality of new wireless technologies, such as WiMAX, that enable new entrants to provide competitive special access services to an entire metropolitan area without digging a single trench. Once just a promising abstraction, WiMAX has now entered the commercial mainstream and is poised to become a full-fledged alternative for both retail and wholesale special access services. Just days after initial comments were filed in this proceeding, AT&T announced its launch of a "large-scale commercial trial" for WiMAX service in and around Atlanta, which follows smaller trials

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36 *See* Cox Business Services Case Studies, http://www.coxbusiness.com/casestudies (last visited July 26, 2005).

37 UNE Fact Report 2004 at III-38; Casto Initial Decl. ¶ 41.

38 *See* Comcast Business Products, http://work.comcast.net/smallbusiness.asp (last visited July 26, 2005).

39 Declaration of Quintin Lew on behalf of Verizon, filed in WC Docket No. 05-25 on June 13, 2005, ¶¶ 34-44 & Attachments a-ee ("Lew Initial Decl.").

40 Casto Initial Decl. ¶ 43.

in New Jersey and Alaska.[41] AT&T's announcement echoes a similar announcement by BellSouth,[42] and likely precedes one by Sprint.[43] SBC itself is currently exploring the use of this technology to provide broadband and special access-like services.[44] As AT&T's chief technology officer observes, WiMAX is competitively attractive because it is "a disruptive technology that will allow you to get all services with better reliability and mobility and at better cost."[45] It has become a competitive threat that wireline special access providers, and those that regulate them, can ignore only at their peril.

B. To the Extent that Proponents of Re-Regulation Present Any Market Share Data At All, That Information Is Incomplete, Inaccurate, or Misleading.

Whereas SBC has provided hard quantitative evidence of broad-based competitive entry, the advocates of re-regulation offer only anecdotes. A number of these commenters—firms that purchase special access services from ILECs and quite often sell such services of their own—assert generically that they face some difficulty in finding competitive suppliers. But they do not provide enough detail about the services they are demanding or the markets at issue, including whether they are even talking about the *price-flex* MSAs for which they seek re-regulation, to allow the Commission to determine whether these experiences reflect any real deficit in competition at all.

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41 Sarmad Ali, *AT&T to Test Wireless Broadband in a Large-Scale Trial this Fall*, Wall St. J., June 20, 2005, at B4; *see also* Brad Smith, *AT&T Plans Broad WiMAX Trial in Atlanta*, Wireless Week, *available at* http://www.wirelessweek.com/toc-newsat2direct/06/16/05 (June 16, 2005).

42 Ali, *supra* n.41.

43 Smith, *supra* n.41.

44 Casto Reply Decl. ¶ 45.

45 Ali, *supra* n.41 (quoting AT&T CTO Hossein Eslambolchi).

The Commission cannot lawfully overlook these gross evidentiary shortcomings or, more specifically, the telling refusal of alternative special access suppliers to provide hard data about the extent of their own competitive entry. These alternative suppliers could, of course, describe their fiber assets exactly. And purchasers of special access could offer precise and exhaustive details of their options to purchase special access from suppliers other than price cap LECs. The refusal of these parties to divulge this information gives rise to a legal inference, binding on the Commission, that the withheld evidence would undermine the objective of these parties in this proceeding—the re-regulation of price cap LECs' special access offerings.[46] The Commission would court reversal on appeal if it granted these parties that objective anyway without forcing them to produce this information.

Even the anecdotes that the proponents of re-regulation offer in place of the hard data within their exclusive control are questionable at best. For example, T-Mobile claims that it has "seen no evidence of increased competitive entry,"[47] and that competitors cannot satisfy T-Mobile's "strong[] prefer[ence]" to purchase all special access links between a base station and an MSC (*i.e.*, base station to central office, interoffice transport, and central office to MSC) from a single provider.[48] But whatever its preferences, **[BEGIN CONFIDENTIAL INFORMATION]**

46 *See, e.g.*, *Int'l Union, UAW v. NLRB*, 459 F.2d 1329, 1336 (D.C. Cir. 1972) ("[W]hen a party has relevant evidence within his control which he fails to produce, that failure gives rise to an inference that the evidence is unfavorable to him.").

47 Comments of T-Mobile USA, Inc., filed in WC Docket No. 05-25, June 13, 2005, at i ("T-Mobile Comments").

48 *Id.* at 9.

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Other claims that proponents of re-regulation portray as big end up looking quite small once examined closely. Ad Hoc sweepingly claims that "its members [can] find no competitive alternatives to ILEC services to meet their broadband business services requirements in the overwhelming majority of their service locations."[52] On close scrutiny, the only substance underlying this claim is a March 2002 member survey suggesting that, "[f]or locations with capacity requirements totaling *four DS-1 circuits or below*, members reported that viable

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50 Likewise, Nextel argues that since its "cell sites frequently are located in out-of-the way locations, such as roadsides," "[i]t is highly unlikely that a competitive provider would find it economically attractive to build *individual, stand-alone* DS1 circuits to serve these remote sites," given the "limited revenue opportunity associated with *stand-alone* DS1s . . . ." Comments of Nextel Communications, Inc., filed in WC Docket No. 05-25, June 13, 2005, at 10 ("Nextel Comments") (emphasis added). But if Nextel has one cell site on the side of a road, it surely has many others along that road, too, and a single right-of-way along with a single ring of fiber would allow a carrier to serve all of them. Just as important, Nextel offers no reason to suppose that an ILEC would enjoy any greater scale economies than its special access rivals in making what would often be *new* deployments along roadsides to accommodate wireless providers.

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52 Comments of the Ad Hoc Telecommunications Users Committee, filed in WC Docket No. 05-25, June 13, 2005, at 9 ("Ad Hoc Comments").

competitive alternatives to the ILEC were available at less than 10% of their locations."[53] This aggregate report of what Ad Hoc's unidentified members consider "viable" special access alternatives is meaningless, not just because it reflects a wholly subjective and self-serving judgment, but also because it is dated and confined, in any event, to the lowest capacity customer locations. It thus says nothing about the status of competition today, nor does it say anything about competition in locations that represent the overwhelming majority of special access bandwidth and demand.

Likewise, the ETI White Paper, cited by a number of commenters, rests on gross factual distortion to suggest that there are very few competitive alternatives to "last mile" connections for large business users.[54] Relying on data filed in 2002, the white paper asserts that CLECs combined connect to less than 1 percent of the 3 million commercial buildings across the country, which, it claims, means that at least 98 percent of commercial buildings have no alternative to ILEC special access.[55] But, as ETI and its sponsors should know, special access demand is highly concentrated, and a majority of the businesses in the 3 million commercial buildings across the country—a figure that includes small retail stores and service providers—purchase only voice-grade services and thus present no demand at all for special access. Moreover, most commercial buildings that do present special access demand have only DS1 connections to the network—which, under SBC's proposal, would largely remain subject to price

53 *Id.* at 9 & n.9 (emphasis added).

54 Competition In Access Markets: Reality Or Illusion, A Proposal for Regulating Uncertain Markets (Economics and Technology, Inc. Aug. 2004) (Attach. A to Ad Hoc Comments) ("ETI White Paper").

55 *Id.* at 16-17.

caps.[56] In any event, the data on which ETI relies is several years old, and takes only a static view of the market. The question here is not how many commercial buildings were connected to CLEC fiber several years ago, but whether CLECs are continuing to expand their competitive presence. As discussed below and in SBC's initial comments, the answer to that question is clearly yes.

Some advocates of re-regulation just make the facts up. For example, several parties complain that ILECs make it difficult for customers to switch to competitors by imposing unreasonable charges and delays when grooming circuits to CLECs.[57] As Mr. Casto observes, however, SBC's cost-based grooming charges can pay for themselves in a matter of days; CLECs have rarely, if ever, availed themselves of all the grooms that SBC is able to provide; and the majority of grooming delays are caused by the *CLEC*, not SBC.[58] SAVVIS and Broadwing, in turn, baldly assert that "it is highly unlikely that there has been any improvement in the state of competition since 2001 . . . in any . . . market, given the intervening bankruptcies of many

[56] Indeed, under the existing triggers, SBC has obtained Phase II pricing flexibility for channel terminations in MSAs that account for only **[BEGIN CONFIDENTIAL INFORMATION]** **[END CONFIDENTIAL INFORMATION]** percent of its channel termination revenues. Casto Reply Decl. ¶ 60. Also, most of the stand-alone DS1 special access circuits that SBC provisions are provided over copper loops. Under the Commission's unbundling rules, ILECs must unbundle two-wire and four-wire copper loops, and conditioned, DSL-capable loops. Competitors may thus provide high-capacity dedicated circuits using DSL, or purchase copper loops to which they may attach their own electronics to provide DS1 services. And, as SBC described in its reply comments in the *Triennial Review Remand* proceeding, only a small fraction of commercial buildings are connected to SBC's fiber, which means that SBC, like everyone else, must build out its fiber network to meet expanding demand for higher capacity special access services. Reply Comments of SBC Communications Inc., filed in WC Docket No. 04-313 on Oct. 19, 2005, at 14-15 ("SBC *TRRO* Reply Comments").

[57] *See, e.g.*, WilTel Comments at 15; Comments of Sprint Corporation, filed in WC Docket No. 05-25, June 13, 2005, at 6-7 ("Sprint Comments").

[58] Casto Reply Decl. ¶¶ 15-17; *see also id.* ¶¶ 18-20.

facilities-based competitive carriers in combination with a precipitous decrease in investment capital available to competitors."[59] These and other commenters assert that barriers to entry—such as high fixed costs,[60] the difficulties of building ubiquitous or far-flung networks,[61] or the difficulties customers have in switching special access providers[62]—mean that competitive entry simply *cannot* exist.

This is nonsense. First, the premise of this claim—that ILECs have ubiquitous fiber networks already extending to most locations—is simply false. SBC, for example, does not have fiber facilities in the ground to all locations and with sufficient capacity to meet demand. In fact, SBC's existing fiber network connects to a relatively small fraction of the commercial buildings in SBC's territory.[63] Consequently, SBC often must build out new facilities to meet expanding demand at both old and new locations—just like its competitors. And, when it does so, it faces the same obstacles as its competitors.

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59 Comments of Broadwing Communications, LLC, and SAVVIS Communications Corporation, filed in WC Docket No. 05-25, June 13, 2005, at 16 ("Broadwing/SAVVIS Comments").

60 *See* Broadwing/SAVVIS Comments at 2; Ad Hoc Comments at 34-35; Comments of the American Petroleum Institute, filed in WC Docket No. 05-25, June 13, 2005, at iii ("API Comments"); Comments of Time Warner Telecom, filed in WC Docket No. 05-25, June 13, 2005, at 12-14 ("Time Warner Telecom Comments").

61 *See* Broadwing/SAVVIS Comments at 13-18; WilTel Comments at 12-13.

62 *See* Broadwing/SAVVIS Comments at 16-17, 25-26; WilTel Comments at 15; Sprint Comments at 6-7.

63 As of October 19, 2004, only **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** commercial buildings in SBC's Southwest region with DS1 and above facilities were connected to SBC's fiber network. Declaration of James E. Keown on Behalf of SBC Communications Inc., filed in WC Docket No. 04-313, CC Docket No. 01-338, Oct. 19, 2004, at ¶ 14 (Attach. D to SBC's *TRRO* Reply Comments).

Second, the purported difficulty of replicating the broad geographic reach of ILEC networks has not insulated any incumbent from successful competition by special access upstarts with less ubiquitous networks, as shown by the steady inroads competitive providers have made in all corners of this market since the 1980s. Indeed, to the extent that customers value ubiquity, they seek it in the nationwide provision of *retail* enterprise services, which are offered today principally by CLECs and IXCs,[64] not in the provision of physical-layer special access services,[65] which no carrier can provide in any event. To the contrary, providers of retail enterprise services make use of a variety of options—including, but not limited to, self-provisioned facilities, third party facilities, UNEs, and other arrangements—to offer end-to-end service to their customers.[66] The greater reliance of some alternative providers on leased facilities has not stopped millions of customers from seeking bids from multiple vendors of special access services and from switching carriers when doing so makes business sense for them.

The Commission, moreover, need not take SBC's word on any of this, because the facts on the ground refute the claim that economic and other barriers somehow prevent competitive entry in the special access market. The number of competitive providers of special access services has continued to grow by leaps and bounds, nearly doubling on average in SBC's Phase II MSAs since 1999,[67] and increasing three- and four-fold in some markets.[68] Moreover, as

64 *See* Casto Reply Decl. ¶ 23 (discussing SBC's experiences competing out of region against such packaged sales by competitive carriers).

65 *See id.* ¶ 22.

66 *Id.*

67 Casto Initial Decl. ¶ 6.

noted above, while some competitors have exited the market during this period, they were replaced by others, resulting in a net increase in wireline competitors in virtually all of the MSAs where SBC has been granted pricing flexibility. This increase, moreover, has come steadily year after year; it has not just been a one-time bubble following initial deregulation.[69] Plainly, if the host of purported barriers to entry were the impediments CLECs claimed, CAPs never would have entered the market over twenty years ago, and they and their CLEC progeny would not have continued to invest billions of dollars to deploy an ever-increasing number of alternative fiber networks. Indeed, SBC avails *itself* of those alternative networks, purchasing local access transport service from a third-party supplier in out-of-region markets from Miami to Seattle. SBC's experience mirrors that of Verizon, which reports that such third-party providers have built robust networks that provide end-to-end connectivity from a customer's building to Verizon's point of presence.[70]

In short, as a factual matter, the pessimism voiced by these advocates of re-regulation flies in the face of competitive reality. And if the Commission ever adopted that pessimism as the basis for telecommunications policy, it would drive straight into a regulatory dead end. Those who claim that competitive entry will always founder on switching costs or greater ILEC ubiquity are not seeking regulatory measures even arguably intended to promote greater special access competition. Instead, they are asking the Commission to give up entirely on competition

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68 *See, e.g.*, Kalt Initial Decl., Fig. 1 (noting that the number of wireline competitors to SBC in the special access market in Abilene, Texas increased from zero in 1999 to four in 2004, and in Los Angeles from four in 1999 to 13 in 2004).

69 *See* Kalt Initial Decl. ¶ 33 & Figs. 1 & 2.

70 Declaration of Robert Pilgrim on Behalf of Verizon, filed in WC Docket No. 05-25 on June 13, 2005, at ¶¶ 12-15 ("Pilgrim Decl.").

and impose price controls indefinitely.[71] That, however, is the only sure way to kill the competitive forces the Commission has successfully cultivated in this market for the past 15 years. Their proposals thus seek a regulatory about-face that is far from justified by the record—and that would be unlikely to survive judicial examination if ever adopted.

C. The SBC/AT&T Merger Will Not Decrease the Competitiveness of the Special Access Market In SBC's Region and Will Increase Competition Out-of-Region.

Several parties argue for greater regulation on the ground that the pending SBC/AT&T merger will decrease the level of competition in the special access market by eliminating AT&T as a competitive supplier of special access services.[72] This is nonsense, as SBC and AT&T have made abundantly clear in the license transfer proceeding.[73] To the extent AT&T deploys local fiber at all, it does so in the vast majority of cases to reach the particular office space occupied by its own retail customers, not common space in the buildings they occupy. AT&T is not a substantial provider of wholesale special access services, and it has only limited local facilities in the SBC region capable of providing such services. In contrast, there are many other CLECs

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71 *See, e.g.*, T-Mobile Comments at 13 ("[I]n virtually all MSAs, there are some areas in which there is no competition and little likelihood that such competition will ever emerge."); CompTel/ALTS Comments at 24-25 (correctly observing that "[f]ostering competition . . . cannot be achieved by tinkering with the price cap regime's productivity factors or reestablishing rates at some regulatorily divined rate of return, which at bottom has the assumption of enduring monopolies," but then suggesting interminable rate-setting nonetheless).

72 *See* Comments of BT Americas Inc., filed in WC Docket No. 05-25, June 13, 2005, at 7-12; Broadwing/SAVVIS Comments at 19-22; WilTel Comments at 12-13; API Comments at 8-9, 12-13; Time Warner Telcom Comments at 10-13; CompTel/ALTS Comments at 27-28; Sprint Comments at 7-8.

73 Joint Opposition of SBC Communications, Inc. and AT&T Corp. to Petitions to Deny and Reply to Comments (Public Version), filed in WC Docket No. 05-65, May 10, 2005, at iii-iv, 23-43 (Joint Opposition) (all page numbers refer to public version); Public Interest Statement of SBC Communications and AT&T Corp., filed in WC Docket No. 05-65, Feb. 21, 2005, at 105 n.347 (Public Interest Statement).

with extensive local networks and much greater wholesale capabilities than AT&T. Indeed, all but a handful of the buildings served by AT&T in SBC's territory are either served already by another CLEC or generate so much special access traffic that they indisputably could be.[74] Similarly, AT&T receives no unique volume discounts from SBC that it could pass on to other carriers, and, contrary to competitors' claims,[75] it does *not* engage in such resale arbitrage in the first place.[76]

There also is no merit to the claim of some commenters that holding aside AT&T's collocation arrangements would leave SBC shy of the pricing flexibility triggers in some MSAs where it has already attained pricing flexibility.[77] SBC and AT&T have already addressed the factual deficiencies of this claim in the merger proceeding.[78] Moreover, as a legal matter, the Commission has never indicated that a carrier could *lose* pricing flexibility under the current rules after an initial grant of such flexibility, and any such policy would contradict the Commission's past practice. For example, CLEC-to-CLEC mergers have necessarily reduced the number of distinct companies collocating in given MSAs, as when AT&T acquired NorthPoint Communications, Inc. ("NorthPoint") and terminated some of NorthPoint's collocation arrangements. But neither the Commission nor any party suggested that this development warranted reevaluation of any ILEC's pricing flexibility status.

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74 *See* Joint Opposition at 36-37.

75 *See* BT Americas Comments at 9; Broadwing/SAVVIS Comments at 7-8, 19-20; Time Warner Telecom Comments at 19-20.

76 Joint Opposition at 26.

77 *See* Time Warner Telecom Comments at 10-11; Sprint Comments at 8 & n.11.

78 *See* Joint Opposition at 38-39.

Finally, the claim of some commenters that a combined SBC/AT&T will refrain from competing out of SBC's region (and instead will engage in "tacit collusion" or "mutual forbearance" with Verizon and other ILECs)[79] is wrong and, for the reasons discussed by SBC and AT&T in the merger proceeding, economically nonsensical.[80] It assumes that SBC will be spending $16 billion to acquire AT&T only to shutter (or at least to let stagnate) the vast majority of its operations.[81]

II. The Advocates of Re-Regulation Have Not Remotely Demonstrated That Special Access Prices Are Unreasonable.

Unable to provide any direct evidence that competition has failed, special access customers nonetheless assert that prices are "too high" and that the government should step in and give them a price break. The argument is untenable in several independent respects. First, these commenters almost invariably cite tariffed base rates, not the discounted prices that most customers (including many if not all of the commenters themselves) actually pay. Second, the commenters compare these barely relevant base rates not to the only relevant benchmark—what

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79 *See, e.g.*, T-Mobile Comments at 11-12; Time Warner Telecom Comments at 3, 11.

80 *See* Joint Opposition at 131-40.

81 *See id.* There is no merit to the suggestion of the American Petroleum Institute that, if the proponents of re-regulation receive the government-mandated special access price break they seek and the SBC/AT&T and Verizon/MCI mergers are approved, AT&T and MCI—alone among special access purchasers that would benefit, at least in the short term, from the regulatory windfall—should be forced to "flow through" such cost savings to their interexchange customers. API Comments at 12-13. In the first place, as API acknowledges, the interexchange market is "robustly competitive." *Id.* at 12. The market therefore would not need any "help" to ensure that cost savings be passed along to customers. Moreover, there is no reasoned basis for limiting such unprecedented regulation of non-dominant carriers in a fully competitive market to AT&T and MCI—it is simply a request to punish SBC and Verizon for API's imagined injuries.

rates would be in a competitive market[82]—but to a set of arbitrary benchmarks, such as what rates would be if price caps were still in effect. In fact, prices in SBC's Phase II MSAs have behaved precisely as economists would predict and as the Commission hoped: while the prices of a handful of high-cost or high-risk services are higher than they were in 2001, overall consumer costs have trended markedly down.

A. The Prices That Customers Actually Pay In SBC's Phase II MSAs Have Declined.

In support of their claims that special access rates are too high, the proponents of re-regulation, as well as the ETI White Paper on which they rely, stack the deck by taking the ILECs' undiscounted base rates as the prevailing prices for special access.[83] This makes as much sense as determining the affordability of air travel prices by looking solely at walk-up, unrestricted fares charged on the day of departure. Just as most airline tickets are bought weeks in advance and with certain restrictions, the overwhelming majority of special access circuits are purchased by customers that bargain for substantial term, volume, and overlay discounts.[84] Studies that ignore those discounts are meaningless. Similarly, the Uri and Zimmerman study,[85] on which many commenters rely, includes only *term* discounts in its calculation of BOCs'

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82 *See* First Report and Order, *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing End User Common Line Charges*, 12 FCC Rcd 15982, 16601 ¶ 42 (1997) ("*Access Charge Reform Order*") ("[A]ccess charges should ultimately reflect rates that would exist in a competitive market.").

83 ETI White Paper at 36; Sprint Comments at 4-5; CompTel/ALTS Comments at 6-9.

84 SBC provides approximately **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** percent of its special access services pursuant to some form of discount. Casto Reply Decl. ¶ 28.

85 Noel D. Uri and Paul R. Zimmerman, *Market Power and the Deregulation of Special Access Service by the Federal Communications Commission*, 13 Info. & Comm. Tech. L. 122 (2004) ("Uri and Zimmerman").

"Optional Payment Plan Rates"; it ignores the BOCs' volume and contract discount offers,[86] both of which have become more important since the inception of pricing flexibility.[87] To omit these discounts from the price story introduces severe inaccuracies. In SBC's case, for example, the MVP overlay discount alone cuts between 9 and 14 percent from customer prices on top of ordinary term discounts.[88]

A more realistic and appropriate way to measure special access prices in Phase II areas is by average revenue per unit, which by definition reflects what customers actually pay after any discounts they receive. And by this measure, SBC's customers are paying significantly lower prices on average, even in nominal terms, in Phase II MSAs than they paid before pricing flexibility began. Since 2000, SBC's prices in these MSAs, as measured by average revenue per unit, have dropped **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** percent for DS1 services and **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** percent for DS3 services.[89] When adjusted for inflation, those price declines are **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** percent and **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** percent, respectively. Thus, even at the lowest bandwidths, customers are

86 *See* Uri and Zimmerman at 129.

87 Casto Initial Decl. ¶¶ 59-65.

88 *Id.* ¶¶ 61-63.

89 *Id.* ¶ 56.

paying significantly less now than they paid under price caps.[90] Mr. Casto provides graphical representations of these price declines:[91] **[BEGIN CONFIDENTIAL INFORMATION]**

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[90] Few parties contest the competitive nature of prices for OCn services. Most simply ignore them altogether. For instance, in its comments Ad Hoc grants that it "has not reviewed and is not providing evidence relative to the pricing for higher bandwidth services." Ad Hoc Comments at 18 n.28.

[91] Casto Reply Decl. ¶ 27, Figs. 2 & 3.

These lower prices are not limited to a handful of pricing plans or a small number of customers with extremely high demand. As Mr. Casto discussed in his initial declaration, SBC offers discounts of up to 45 percent off of month-to-month rates under a variety of plans that are open to all special access customers.[92] In addition, SBC's MVP plan, which provides overlay discounts of an additional nine to 14 percent, is open to any customer purchasing at least $10 million in special access services.[93] Moreover, SBC has proposed or entered hundreds of individually negotiated contract tariffs that offer discounts of up to **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** percent off of basic schedule rates.[94] In short, pricing flexibility has benefited a wide cross-section of all customers, not just a select few.

All this said, even SBC's *tariffed base rates* in Phase II MSAs are generally no higher than they were in 2001, when Phase II pricing flexibility was first implemented in SBC's territory.[95] This is true even without adjusting for inflation, which further lowers SBC's current

92 Casto Initial Decl. ¶ 63.

93 The MVP discount is currently subscribed to by **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** customers. Casto Reply Decl. ¶ 61.

94 Casto Initial Decl. ¶ 63.

95 *Id.* ¶ 58 & n.49. As Mr. Casto explains, SBC increased rates for certain special access services in Phase II MSAs in California because those rates were set substantially below market levels due to reductions in those rates when they were subject to price caps. In particular, those rates were held below the 12-month rates of some of SBC's competitors in those MSAs, and significantly below SBC's month-to-month rates for comparable services in other regions. SBC's one-time rate increase for those services simply represented an effort to move monthly rates closer to market levels and other SBC month-to-month DS1 rates. Casto Reply Decl. ¶ 35.

base rates in real terms.[96] The proponents of re-regulation respond by pointing to specific instances where base rates (not actual discounted rates) have increased, but these prove nothing.[97] Prices move in competitive markets in response to supply and demand, and the mere fact that an isolated price may *increase* to reach its competitive equilibrium obviously does not establish that the sellers have market power.[98] It would be more surprising if, after years of mechanical X-factor decreases untied to actual productivity gains, at least some prices did *not* increase once permitted to float to competitive levels. Indeed, the Commission itself predicted that some prices would increase with the introduction of pricing flexibility.[99]

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[96] *See* Tenth Report and Order, *Federal-State Joint Board on Universal Service; Forward-Looking Mechanism for High Cost Support for Non-Rural LECs*, 14 FCC Rcd 20156, 20287 ¶ 311 (1999) ("We recognize that the cost of purchasing and installing switching equipment changes over time. . . . [W]e affirm our tentative conclusion . . . to modify the data to adjust for the effects of inflation . . . .").

[97] *See* Ad Hoc Comments at 20. Even the cherry-picked examples of ostensible base-tariff rate increases cited by proponents of re-regulation are misleading. Ad Hoc points to a 21 percent increase in some Pacific Bell Phase II DS1 prices in May 2003 as evidence of substantial base rate increases in SBC pricing flexibility areas. *Id.* But that price increase, which was Pacific Bell's *only* non-trivial special access rate increase since January 2001, Casto Reply Decl. ¶ 36, simply returned monthly base rates to market levels. Before qualifying for Phase II pricing flexibility, the month-to-month DS1 rates in the legacy Pacific Telesis (i.e., Pacific Bell) MSAs in California were capped substantially below market levels: below the 12-month rates of some of SBC's competitors in those MSAs, and significantly below SBC rates for comparable services in other regions. *Id.* ¶ 35. And, even taking this rate increase into account, SBC's ARPU for DS1 special access services in Phase II MSAs in the Pacific Bell region declined by **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** percent in nominal terms and **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** percent in real terms between 2001 and 2004. *Id.* ¶ 36.

[98] *See* Reply Declaration of Professor Joseph P. Kalt on Behalf of SBC Communications Inc., filed in WC Docket No. 05-25 on July 29, 2005 ¶¶ 19-21 ("Kalt Reply Decl.") (Tab C).

[99] *Pricing Flexibility Order* at 14301 ¶ 155 ("We recognize that the regulatory relief we grant upon a Phase II showing may enable incumbent LECs to increase access rates for some customers. We conclude that this relief nonetheless is warranted upon a Phase II showing . . . because our rules may have required incumbent LECs to price access services below cost in certain areas."). The proponents of re-regulation dismiss this possibility out of hand without any

Finally, the prices one would *most* expect to rise in competitive market conditions are those for service plans that customers are especially likely to purchase if they think they might change their minds and switch to another provider or cancel service altogether shortly after the ILEC incurs the fixed costs of providing service to those particular customers. The tariffed services offered on a month-to-month basis in Phase II MSAs, where competitive alternatives are most readily available, fall into precisely that category. These month-to-month base rates must thus permit ILECs to recover over a shorter period the fixed costs, such as the cost of deploying a new loop to a customer location, that might otherwise be stranded.[100] The fact that a few of these base rates have risen since the introduction of pricing flexibility indicates not that ILECs have market power, but that lower prices will make it impossible to cover the costs of serving this particular category of customers.

B. The Various Benchmarks Used to Suggest That ILEC Rates Are "Too High" Are Specious and Misleading.

Not only do the proponents of re-regulation start with the wrong ILEC prices, they also compare them to meaningless benchmarks. The *only* relevant point of comparison is what prices would be in a competitive market. The four benchmarks that commenters use to suggest that special access prices are somehow "too high"—rates under price-cap regulation, TELRIC prices, CLEC prices, and prices for long-haul fiber—do not approach that mark.

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explanation why. Sprint, for instance concludes without any explanation or data that "[t]here is no reason to believe that prices for the services in question had been kept artificially low under price caps." Sprint Comments at 4 n.6. *See also* ATX Comments at 33 (similarly offering no data or basis for such a conclusion). Particularly given the Commission's prediction that some prices would increase with the introduction of pricing flexibility, the burden is obviously on these commenters to explain why *no* prices should increase.

100 *See* Casto Reply Decl. ¶ 38.

1. Rates under price-cap regulation. Many commenters compare current base rates in price-flex areas to the prices that customers would be paying if price caps were still in effect.[101] But the price-cap rate reflects years of rate-of-return regulation followed by years of mechanical and often aggressive X-factor price decreases—which, as the D.C. Circuit has found, bear no necessary relation to any special productivity gains.[102] Nor did the Commission *intend* to approximate any such gains under CALLS.[103] Under these circumstances, it would be quite fortuitous if price cap rates *were* closely aligned with the economic costs of the underlying services. The Commission has recognized (even if proponents of re-regulation do not) that this fortuity is most unlikely. Indeed, the Commission's rationale for replacing price caps with pricing flexibility has always been that price regulation of any kind is much less likely than market forces to align rates with cost.[104]

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[101] *E.g.*, Declaration of Janet S. Fisher on Behalf of Global Crossing North America, Inc., attached to CompTel/ATLS Comments; Ad Hoc Comments at 21; Sprint Comments at 2 (complaining that its 2004 special access bill would have been millions of dollars lower "had those services been available at price cap rates").

[102] *See X-Factor Decision*, 188 F.3d at 525-29.

[103] Sixth Report and Order in CC Docket Nos. 96-262 and 94-1; Report and Order in CC Docket No. 99-249; Eleventh Report and Order in CC Docket No. 96-45, *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low Volume Long Distance Users; Federal-State Joint Board on Universal Service*, 15 FCC Rcd 12962, 12978 ¶ 38 (2000) ("*CALLS Order*").

[104] *See* Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, *Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, 12 FCC Rcd 16642, 16698-99 ¶ 144 ("*Fourth Price Cap Performance Review Order*"); *see also Access Charge Reform Order* at 16001 ¶ 44 (noting that "a market-based approach to reducing interstate access charges will, in most cases, better serve the public interest").

2. *TELRIC prices*. Some commenters cite TELRIC loop and transport prices as a measure for where special access prices "should be" in a competitive market.[105] This is also nonsense. First, although the Commission has recognized that the availability of UNEs can exert downward pressure on special access prices,[106] it has found, with the D.C. Circuit's approval, that permitting carriers to indiscriminately purchase the functional equivalent of special access services at TELRIC would harm the development of competition by, among other things, "undercut[ting] the market position of many facilities-based competitive access providers," a "mature source of competition in telecommunications markets."[107] Indeed, as the Commission has also indicated, relying on TELRIC as a benchmark for pricing special access services would effectively write the section 251(d)(2) impairment standard out of the Act by driving special access rates down to the level of their UNE counterparts.[108]

In any event, in a rulemaking proceeding launched in 2003, the Commission expressed serious concern that, as currently formulated, TELRIC may be inappropriate for use in *any* context because it is internally inconsistent, indeterminate in application, and unable to convey

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105 *See, e.g.*, WilTel Comments at 17, Nextel Comments at 16-17.

106 Order on Remand, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, 20 FCC Rcd. 2533, 2572-73 ¶ 65 (2005). In its reply comments, BT Americas disingenuously attributes to SBC the proposition that "special access pricing should, in a competitive market, go down to the UNE (TELRIC) rates." Reply Comments of BT Americas Inc., filed in WC Docket No. 05-25, July 12, 2005, at 3 ("BT Americas Reply Comments"). That proposition is wrong, and SBC in fact argues the opposite, given TELRIC's inability to mimic conditions in a genuinely competitive market (as discussed in the text). At the same time, the Commission itself has found that, so long as TELRIC-priced UNEs sometimes remain available as alternatives to special access services, that regulatory entitlement will exert (artificial) downward pressure on ILEC special access rates. *See Triennial Review Remand Order* at 2572-73 ¶ 65.

107 *Supplemental Order Clarification* at 9597 ¶ 18.

108 *Id.* at 9592-96 ¶¶ 9-16.

appropriate signals about prices in a competitive market.[109] For that reason alone, it would be arbitrary and capricious, while the TELRIC reform proceeding is pending, for the Commission to use TELRIC-based rates as a benchmark for judging the cost basis of special access prices.

3. CLEC prices. At least one commenter attempts to draw comparisons between ILEC special access prices and those of competitive providers.[110] But it is impossible to tell what competitor prices this commenter is even contemplating, let alone evaluate the comparisons. CLECs are not required to tariff or otherwise report their prices, and there is no CLEC "index" special access price. Moreover, it is reasonable to expect ILEC prices to exceed CLEC prices in the normal case. CLECs enter a market by first providing service in the highest-density, highest-demand, highest-bandwidth, and cheapest-to-serve segments of the market, yielding per-line costs (and prices) below that of the ILEC, which is required to serve *all* customers at *all* bandwidths *throughout* the MSA.[111] Put differently, lower CLEC prices reflect the freedom of these new entrants to choose their markets, not ILEC market power. In addition, ILECs often pursue a strategy of offering a product with superior quality and service at a premium price. This type of "gold-standard" service is common in competitive markets and not evidence of market power.

4. Long-distance fiber prices. Dr. Wilkie, retained by T-Mobile, appears to advocate the use of mileage charges on trans-continental and even inter-continental fiber routes as a point of

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109 *TELRIC NPRM* at 18949 ¶ 7.

110 *See* CompTel/ALTS Comments at 25-26.

111 *See Texas Office of Pub. Util. Counsel v. FCC*, 265 F.3d 313 (5th Cir. 2001) ("*TOPUC*") ("In a competitive market, a carrier that subsidizes rural or poor customers by charging below-cost rates while billing above-cost rates to urban customers will be undercut by a competitor offering at-cost rates to urban end-users.").

comparison for end-user channel termination rates in urban areas.[112] This is comparing apples and orangutans, and Dr. Wilkie's analysis is flawed on multiple levels.[113] Though claiming to normalize the data for distance and economies of scale, Dr. Wilkie entirely ignores the obvious differences between laying fiber along a railroad line across Nebraska and trenching in downtown Los Angeles. The costs of acquiring rights of way and laying conduit associated with urban routes and long haul routes are not remotely comparable. Moreover, there is far greater flexibility in planning routes for long-haul fiber: there are more possible paths between Boston and San Francisco than there are between two points in a densely populated urban area. Finally, Dr. Wilkie draws his comparative data from the period shortly after the recent crash in intercity fiber prices caused by years of feverish overbuilding by IXCs—many of which, like MCI, have gone through bankruptcy and shed from their books much of the cost of deploying those facilities.[114]

III. The Proponents of Re-Regulation Have Failed to Show That ILECs Are Somehow Earning "Too Much" On Special Access Services.

Unable to show that competition has lagged or that special access *prices* are too high in any objective sense, the advocates of re-regulation resort once more to the claim that ILEC special access *rates of return* are too high—and thus, they say, proof of enduring ILEC market power.[115] But that claim rests entirely on an accounting anomaly, not economic reality. Every

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112 Declaration of Simon J. Wilkie on behalf of T-Mobile Comments, filed in WC Docket NO. 05-25 on June 25, 2005, at Attach. B at 6-8 ("Wilkie Initial Comments").

113 *See* Kalt Reply Decl. ¶¶ 23-24; Casto Reply Decl. ¶ 31.

114 *See* Casto Reply Decl. ¶ 31.

115 *See* Ad Hoc Comments at 29; ATX Comments at 7-10; Broadwing/SAVVIS Comments at 3, 28; BT Americas Comments at 5; CompTel/ALTS Comments at 5-6; Nextel Comments at

commenter asserting the claim derives ILEC rate-of-return figures from the data reported in ARMIS, whose frozen separations rules cause carriers to understate their aggregate costs of providing special access, potentially by billions of dollars. The BOCs' supposedly "jaw-dropping"[116] rates of return are just an artifact of the ensuing mismatch between these understated accounting costs and actual revenues. And even were it otherwise, the Commission could not lawfully ratchet down the BOCs' margins on special access services while leaving intact the negligible and sometimes negative margins on the other services BOCs are compelled to provide.

As SBC explained in its initial comments (at 24-33), the service-specific cost data reported in ARMIS are obtained by applying the Part 36 "separations" rules, which require ILECs to apportion their plant investment and other costs to myriad categories, and then further separate these categories of costs into interstate and intrastate amounts. The interstate portions of these separated (regulated) costs must then be apportioned among interexchange services and rate elements—such as special access, carrier common line, or traffic sensitive (including switched access)—under Part 69 of the Commission's rules, and reported as such in ARMIS.[117]

As SBC's economists (and others) have explained,[118] and as the Commission has recognized,[119] this sorting process will always yield, even in the best of circumstances, somewhat

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13; T-Mobile Comments at 7, 11; Time Warner Telecom Comments at 15-16; Comments of XO Communications, Inc., filed in WC Docket No. 05-25, June 13, 2005, at 5 ("XO Comments").

116 T-Mobile Comments at 10-11; Time Warner Telecom Comments at 15-16.

117 *See* Toti Initial Decl. ¶¶ 9, 11; SBC's Opening Comments at 26.

118 *See, e.g.,* Declaration of John C. Klick and Michael R. Baranowski on Behalf of SBC Communications Inc., filed in WC Docket No. 05-25 on June 13, 2005, ¶ 27 ("Klick & Baranowski Initial Decl."); Kalt Initial Decl. ¶ 80-82; *see also* Declaration of Alfred E. Kahn and William E. Taylor on Behalf of BellSouth Corporation, Qwest Corporation, SBC

arbitrary results given the need to allocate shared and common costs. But the current rules yield especially unreliable allocations, as the Commission has further acknowledged, because they are "outdated" and "out of step with today's rapidly-evolving telecommunications marketplace."[120] Indeed, the gulf between reality and the accounting books is growing wider with each passing year. In 2001 the Commission froze the separations factors, requiring ILECs to allocate their expenditures among services using the same percentages as in 2000.[121] Since the freeze, the BOCs have had to base their Part 36 allocations on plant-usage studies completed in 2000 or before, even though the mix and type of services that the BOCs have provided since then has continued to change.[122]

The freeze has particularly distorted the cost figures for special access. During the five-plus years since the BOCs' last plant-usage studies, special access volumes and revenues have grown substantially, while switched access lines and combined interstate common-line and

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Communications, Inc. and Verizon, filed in RM-10593 as an attachment to Comments of BellSouth, Dec. 2, 2002, at 7-9.

119 Because "interstate and intrastate services are largely provided over common facilities," the Commission has previously found "no evidence that there was an economically meaningful way to divide and measure the facilities used for the provision of interstate service from facilities used for provision of intrastate services." Fourth Further Notice of Proposed Rulemaking, *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 13659, 13669 ¶ 63 (1995) ("*Fourth Further Price Cap NPRM*"); *see also* Order on Reconsideration, *Policy and Rules Concerning Rates for Dominant Carriers*, 6 FCC Rcd 2637, 2730 ¶ 199 (1991) (category-specific returns reported in ARMIS "do[] not serve a ratemaking purpose."); SBC's Opening Comments at 24-27.

120 *See* Report and Order, *Jurisdictional Separations and Referral to the Federal-State Joint Board*, 16 FCC Rcd 11382, 11383 ¶ 1 (2001) ("*Freeze Order*"); *see also id.* at 11389-90 ¶ 12; SBC's Opening Comments at 26-27 & n.80.

121 *See Freeze Order* at 11383 ¶ 2.

122 *See* Toti Initial Decl. ¶ 15; Klick & Baranowski Initial Decl. ¶¶ 27-28.

traffic-sensitive revenues have significantly decreased.[123] An increasing fraction of what the BOCs are spending to provide service should thus be attributed to special access.[124] Yet the *Freeze Order* bars the BOCs from changing the fractions of their investment and expense figures that they allocate among the ARMIS elements associated with special and switched access.[125] As a result, while the BOCs' special access *revenues* are accurately reported in ARMIS, the costs of producing those revenues are not. The investments and expenditures tagged to special access services in ARMIS are far too low, resulting in a grossly inflated apparent rate of return.[126]

For that reason, studies like the Uri and Zimmerman report,[127] which rely on unadjusted ARMIS-based rates of return, are meaningless.[128] The same is true for Gately's claim that the operating expenses associated with provisioning special access lines have "trend[ed] down much

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123 *See* SBC's Opening Comments at 29-30; Reply Declaration of David Toti on Behalf of SBC Communications Inc. filed in WC Docket No. 05-25 on July 29, 2005 ("Toti Reply Decl.") (Tab D); Toti Initial Decl. ¶¶ 18-19.

124 *See* Toti Initial Decl. ¶ 20.

125 *See* SBC's Opening Comments at 30; Toti Initial Decl. ¶¶ 15, 17.

126 *See* SBC's Opening Comments at 30; Toti Initial Decl. ¶¶ 4-5, 17-18. Indeed, historical ARMIS cost allocation data for all BOCs confirms that the Freeze has caused a significant under-reporting of costs to special access. Before 2001, increases in ARMIS-reported interstate special access costs as percentages of total costs subject to separations tended to keep pace with increases in ARMIS-reported interstate special access revenues as percentages of total revenues subject to separations. *See* Toti Initial Decl. ¶ 21. *After* 2001, this relationship was severed: interstate special access revenues as a percentage of total revenues subject to separations continued to grow, but the percentages of investment and expenses allocated to interstate special access for major plant accounts *flattened out* during this same period. *See* Toti Initial Decl. ¶¶ 22-28; SBC's Opening Comments at 31.

127 Uri and Zimmerman, *supra* n.82.

128 *See* Toti Reply Decl. ¶¶ 7-12.

more quickly" than revenues.[129] That claim, too, is based on ARMIS data, which grossly underreport true expenses along with investment.[130]

A few commenters try to sweep ARMIS's defects under the rug, but to no avail. Ad Hoc suggests that these misallocations are "minor" and "at the margins,"[131] but in fact the misallocations potentially involve billions of dollars for the BOCs.[132] Ad Hoc is also mistaken in claiming that the misallocations "do not change from period to period" and thus do "not affect the overall integrity of *trends* in the data."[133] Far from remaining constant, the misallocations have been growing significantly, since special access services have represented an ever-larger fraction of the BOCs' service mix. Even the Uri and Zimmerman report confirms that demand for special access has grown dramatically "in both relative and absolute terms"[134] and that the

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129 *See* Declaration of Susan M. Gately on behalf of Ad Hoc Telecommunications Users Committee filed in WC Docket No. 05-25 on June 13, 2005, at ¶ 15 & New Figure 3.4 ("Gately June 2005 Decl.").

130 *See* Toti Reply Decl. ¶¶ 21-23.

131 Ad Hoc Comments at 29.

132 For example, while investment in Circuit Equipment grew $6.5 billion from 2000 to 2004, the freeze required SBC to apportion only $1.7 billion of this growth to the "Wideband" categories, the interstate components of which are assigned entirely to special access. *See* Toti Initial Decl. ¶ 34. An assumption that 50 percent of the growth in Circuit Equipment since 2000 should have been allocated to Wideband yields $1.1 billion of additional interstate special access investment. The result is even starker if one reasonably assumes that, but for the Freeze, increases in interstate special access costs as percentages of total costs subject to separations would have continued to keep pace (as they historically did before the freeze) with increases in interstate special access revenues as percentages of total revenues subject to separations: $1.5 billion of additional Circuit Equipment would have been allocated to interstate special access. *See id.* ¶¶ 35-36. Moreover, this is just one example; other cost allocations (of expenses as well as plant investment) would have to be recalculated in order to correct for the distortions caused by the freeze. *See* Toti Reply Decl. ¶ 10; Toti Initial Decl. ¶ 37; SBC's Opening Comments at 32.

133 Ad Hoc Comments at 29 (emphasis in original).

134 Uri and Zimmerman at 125.

percentage of special access lines relative to all access lines has increased from 8.9 percent in 1996 to 41 percent in 2002.[135] As time passes, moreover, the year-2000 allocation factors diverge ever further from reality.[136]

Nor is there any truth to Gately's claim, invoked by a few commenters,[137] that the ARMIS data somehow *over-allocate* the BOCs' costs to special access. To make that claim, Gately contends that special access lines account for only 2.5 percent of total BOC access lines,

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135 *Id.* at 126.

136 Ad Hoc contends that SBC is somehow estopped from criticizing ARMIS data because one of its witnesses used ARMIS cost data in a state UNE case. *See* Ad Hoc Comments at 29-30 n.54 (citing SBC Illinois Ex. 2.2 (Surrebuttal Testimony of Dr. Debra J. Aron), Docket No. 02-0864 (I.C.C. filed Mar. 5, 2004) ("*Illinois-Aron Surrebuttal Testimony*")). That is absurd. In the first place, in the proceeding at issue, SBC's witness, Dr. Aron, used *aggregated* ARMIS-reported costs associated with loops, switching, and switched transport to "identify[] a benchmark of the total cost actually incurred for entire network elements." *Illinois-Aron Surrebuttal Testimony*, at 8-9. Dr. Aron expressly distinguished this objective from the re-regulation advocates' present objective of "determining specific point estimates for earned rates of return for *special access services* for the *purpose of assuming market power*." *Id.* at 7 (emphasis in original). Indeed, Dr. Aron made clear that, for multiproduct firms, "it would be economically questionable to use a cost accounting system to identify the rate of return for any specific service, because of the fact that some costs are shared or common." *Id.* at 7-8. Moreover, for her UNE cost analysis, Dr. Aron sought to avoid the "arbitrary" allocations imposed by the separations process by "'revers[ing] out' the interstate/intrastate allocations to restore total investment for each element." *Id.* at 8-9. Nothing in SBC's prior UNE-related testimony undermines its central point here that ARMIS data are unreliable for the purpose of calculating service-specific rates of return for services, such as special access, whose volumes have exploded over recent years. More important, irrespective of Dr. Aron's testimony in that proceeding, the Commission's duty here is to determine what, if any, relevance ARMIS data have in evaluating the state of competition in the special access market. For the reasons discussed in the text, ARMIS data cannot be used to estimate a service-specific rate of return and thus cannot be relied upon to evaluate the profitability, much less the competitiveness, of special access services.

137 Gately June 2005 Decl. ¶¶ 1-2; *see also* ETI White Paper at ii; Declaration of Susan M. Gately on behalf of Ad Hoc Telecommunications Users Committee, *Application of AT&T Corp. and SBC Communications Inc. Pursuant to Section 214 of the Communications Act of 1934 and Section 63.04 of the Commission's Rules for Consent to the Transfer of Control of AT&T Corp. to SBC Communications Inc.*, WC Docket No. 05-65 (May 10, 2005), cited by Nextel Comments at 13 n.30, CompTel/ATLS Comments at 2, 5.

but that, under ARMIS, interstate special access services account for almost one third of the BOCs' total interstate investment.[138] Each end of this comparison is flawed. First, in calculating the 2.5 percent figure, Gately assumes that the BOCs have only "about 4 million" special access loops—compared to more than 158-million common line local service loops—but the 4 million number is unsubstantiated and almost certainly understates special access lines by well more than an order of magnitude.[139] The very 2002 FCC report that Gately cites for this 4 million number actually places the figure at 94.2 million.[140] And even Uri and Zimmerman put the 2002 percentage of special access lines relative to all access lines at just under 41 percent—a far cry from Gately's 2.5 percent.[141]

Gately errs on the investment side of her analysis as well, where she compares special access investment to the total portion of BOC investment allocated to the *interstate* jurisdiction. Because Gately is looking at special access lines as a percentage of all access lines on the line-

138 Gately June 2005 Decl. ¶ 13; ETI White Paper at 33-35.

139 *See* Gately June 2005 Decl. ¶ 14; ETI White Paper at 33-35.

140 *See* ETI White Paper at 33 n.62 (citing Industry Analysis and Technology Division, Federal Communications Commission, *Statistics of Communications Common Carriers 2002/2003*, March 2, 2004 ("*SOCC*") at Table 2.6); Toti Reply Decl. ¶ 16.

141 Uri and Zimmerman at 126. It is possible that Gately is counting high-capacity circuits rather than voice-grade equivalents ("VGEs"). But as Mr. Toti explains, if this was Gately's intended approach, it also would be inappropriate, because high-capacity circuits are radically more expensive to deploy and maintain than voice-grade loops. *See* Toti Reply Decl. ¶ 17 & n.31. Gately's line count data is seriously flawed in other respects as well. For instance, in calculating the total BOC number of lines (*i.e.* the line denominator), Gately appears incorrectly to use the number of switched lines for all *ILECs* (158 million). The number of *BOC* switched lines from the 2002 FCC statistics that she cites is 147 million. *See Id.* ¶ 18. Furthermore, Gately inexplicably and unnecessarily relies on access line counts from *2002*, even though she compares these line counts to investment figures from 2004. *See* June 2005 Gately Decl., Updated Table 3.2 (citing FCC ARMIS Report 43-04, Access Report: Table I, YE 2004); Toti Reply Decl. ¶ 19. In 2004, the combined BOCs' special access line count reported in ARMIS was 121.8 million. *See* Toti Reply Decl. ¶ 17 n.35; Toti Initial Decl., Attach. 1.

count side of her comparison, she should be looking at special-access investment as a fraction of *all* investment, no matter how that investment is allocated jurisdictionally.[142] In 2004, special access accounted for only 11 percent of combined interstate plus intrastate investment as recorded in ARMIS—far lower than the 31.7 percent result that Gately obtains.[143] In short, the combined effect of Gately's errors is to make the special-access share of access lines look artificially small while making the special-access share of investment look artificially large. Correcting these errors shows that Gately's comparative analysis does nothing to disturb—and in fact reinforces—SBC's point that ARMIS severely *understates* the BOCs' special access investments.[144]

In any event, as discussed in SBC's opening comments (at 6-7, 35-37), even if the BOCs' special access margins *were* somehow "too high," the Commission could not lawfully force those margins down while ignoring the effect on the BOCs' enterprise-wide returns, which have dropped from approximately 16 percent in 1999 to just 13 percent in 2004.[145] As carriers of last resort, BOCs are required to provide a full complement of services, many at intentionally cross-subsidized prices.[146] If the BOCs' special access earnings were as high as the proponents of re-

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142 *See* Toti Reply Decl. ¶ 13.

143 *See id.* ¶ 15.

144 *See id.* ¶ 20.

145 *See id.* ¶ 11; Toti Initial Decl. ¶ 39.

146 *See, e.g.*, *Qwest Communications Int'l, Inc. v. FCC*, 398 F.3d 1222, 1238 (10th Cir. 2005); *NASUCA v. FCC*, 372 F.3d 454, 459 (D.C. Cir. 2004) (FCC acknowledged that access charges continue to provide implicit subsidies); Order on Remand, Further Notice of Proposed Rulemaking, and Memorandum and Order, *Federal-State Joint Board on Universal Service*, 18 FCC Rcd 22559, 22561, 22567-68, 22571-72, 22621-22 ¶¶ 2, 14, 15, 22, 105 (2003) (describing implicit support mechanisms and concluding there was no basis for increasing federal support for non-rural ILECs); *cf.* Order and Notice of Proposed Rulemaking, *Special Access Rates for Price*

regulation allege, then, simply as a mathematical matter, the rates of return on the BOCs' other services would have sunk very far below 13 percent, often into negative territory. It would be arbitrary and capricious, as well as a likely violation of the Takings Clause, for the Commission to ratchet down special access margins without simultaneously ensuring greater margins on these other services.[147]

IV. The Various Proposals for Increased Regulation Would Be Counterproductive

As SBC has shown, there is no plausible basis for reversing course on the Commission's 15-year initiative to rely increasingly on competition rather than regulation to serve the public interest in the special access market. This does not stop certain special access customers, however, from proposing a wide range of intrusive new forms of government intervention. In each case, the proposed "reform" would be as harmful to free market dynamics in the long term as it is unnecessary to protect consumer interests in the short term.

A. The Commission Should Not "Reinitialize" Price Cap Rates

Many commenters ask the Commission to "reinitialize" price caps and force special access prices down to various arbitrary benchmarks. Some commenters suggest TELRIC loop

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Cap Local Exchange Carriers, 20 FCC Rcd 1994, 2000 ¶ 14 (2005) ("*Special Access NPRM*") (noting that the CALLS plan "represents a five-year interim regime designed to phase out implicit subsidies and (as it pertains to access charges) to move towards a more market-based approach to ratesetting").

147 *See X-Factor Decision*, 188 F.3d at 528 (Commission justifiably retained low-end adjustment mechanism based on "the Constitution's takings clause, which forbids the imposition of confiscatory rates without just compensation") (citing *Fourth Price Cap Performance Review* at 16704 ¶ 157 (1997); *Dusquesne Light Co. v. Barasch*, 488 U.S. 299, 307-08 (1989)); *see also Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("[T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. . . . [I]t is important that there be enough revenue not only for operating expenses but also for the capital costs of the business [including] service on the debt and dividends on the stock.").

and transport prices as the appropriate benchmark;[148] others suggest some undefined (and impossible-to-calculate) index of CLEC rates;[149] while others suggest levels corresponding to a fixed rate of return as calculated using ARMIS cost data.[150] SBC has already explained why each of these benchmarks would be untenable as a means of evaluating the reasonableness of special access prices as they currently stand.[151] *A fortiori,* reducing prices to these levels by regulatory fiat would be arbitrary and unlawful.

More fundamentally, as discussed in SBC's opening comments (at 37-40), a nominal price cap regime interrupted by periodic re-initialization of prices to reflect "acceptable" rates of return is just old-style rate-of-return regulation by another name. It would present the same perverse incentives that led the Commission in the first place to abandon such regulation in favor of price caps. Much like formal "sharing" obligations, which the Commission rightly eliminated years ago for the same reason, reinitialization would weaken each price cap LEC's incentives to cut costs and improve efficiency in the hope of earning higher margins, given the probability that regulators would just take those margins back in the next round of reinitialization.[152] For similar

148 *See* WilTel Comments at 17-18; ATX Comments at 17-22.

149 CompTel/ALTS Comments at 25-30.

150 *See, e.g.*, Ad Hoc Comments at 41; Nextel Comments at 4. Most commenters suggest a 11.25 percent rate of return as an appropriate benchmark, but others suggest a lower rate based on reductions in the prime rate and Treasury yields since 1990, when the 11.25 percent figure was set. *See* Ad Hoc Comments at 40-41; ATX Comments at 23-24. This has the trends exactly backwards: ILECs today face competitive risks unimagined in 1990, and their cost of capital has correspondingly increased.

151 *Supra* II.B.

152 Kalt Initial Decl. ¶ 70. As the Commission has explained, sharing is "a serious impediment to deregulation" because it tends to undermine free-market incentives to increase efficiency. *Fourth Price Cap Performance Review Order* at 16701 ¶ 151; *see also* Order on Reconsideration, *Price Cap Performance Review for Local Exchange Carriers*, 14 FCC Rcd

reasons, if the Commission were now to retreat to this largely discredited form of regulation, despite years of assurances that carriers could retain the fruits of their efficiencies, it would impair not just the future health of the special access market, but its own institutional credibility as a regulator, as to that market and all others. The price of losing that credibility is to chill whatever investment the Commission might hope to stimulate, in any market, by promising a greater reliance on market forces to serve the needs of consumers.

For an independent reason as well, it is far preferable, from a long-run market perspective, to leave price caps at their present levels than to risk lowering them to non-compensatory levels through reinitialization (or, as discussed in the next section, through misconceived X-factor reductions). Whereas the market itself will correct high prices by inducing greater competitive entry, the market *cannot* "correct" erroneously low price caps: the affected ILEC would remain undercompensated, and the artificially low prices the ILEC is compelled to charge would deter all potential rivals from entering the market.[153] In the long run, no one would benefit from that outcome.

1684, 1688 ¶ 6 (1998) (sharing "was inconsistent with the general competitive paradigm that was established by the Telecommunications Act of 1996"). The Commission has tentatively concluded once more that it "should not now require LECs to share earnings if we decide to adopt a price cap plan for special access services." *Special Access NPRM* at 2011 ¶ 44. That conclusion is correct. The few parties that support resuscitating this "last vestige of rate of return regulation" (*id.* at 2011 ¶ 43) offer no reasoned basis for that proposed about-face. *See* ATX Comments at 26-27; Ad Hoc Comments at 48-49.

[153] *See* Kalt Initial Decl. ¶ 19.

B. The Commission Should Not Adopt a Productivity-Based X-Factor or a Demand-Based "G-Factor."

Many commenters also ask the Commission to adopt some kind of X- or g-factor[154]—*not* because they can prove the kinds of productivity enhancements or increased scale economies that might justify such a one-way ratchet, but simply because an X- or g-factor would produce additional price breaks. The Commission has been reversed repeatedly for adopting X-factors that lack a substantial empirical foundation.[155] Adopting such a factor on this record would prompt yet one more reversal.

1. The record establishes no basis for imposing an X-factor.

The traditional function of an X-factor is to reflect the extent to which a price cap LEC's expected future productivity gains will exceed expected productivity gains in the economy as a whole.[156] Those advocating the adoption of an X-factor here make no serious effort to prove that price cap LECs will in fact enjoy such productivity gains on the services actually subject to price caps. Instead, they start with the premise that ILEC rates of return (as measured by ARMIS data) are too high and conclude that an X-factor would usefully bring rates of return down to

[154] *See* Ad Hoc Comments at 43-46 (proposing that the Commission adopt an "implicit X-Factor" "akin to the Frentrup and Uretsky" model); Nextel Comments at 19-20 ("The Commission . . . must adopt a new X-factor that approximates the substantial productivity gains that the BOCs have been able to achieve year after year for the past several years."); T-Mobile Comments at 19 ("An improved, revised form of price cap regulation should include a productivity factor that reasonably accounts for the price cap ILECs' scale economies in the provision of special access").

[155] *See Texas Office of Pub. Util. Counsel v. FCC*, 265 F.3d 313, 328-29 (5th Cir. 2001) (invalidating X-factor adopted in *CALLS Order*); *X-Factor Decision* (invalidating Commission's choice of X-factor as unsupported by any actual productivity evidence).

[156] *X-Factor Decision,* 188 F.3d at 524-25.